

Inflation: A Coward's Weapon of Choice



Okay. I said it. As provocative as the title of this article may be, it simply expresses my frustration and indignation regarding the current path of the U.S. Dollar. As I have often stated; "Inflation is Theft." Simply put, if you labor for many years to accumulate one million

dollars in the bank and I do not, but instead just print the same million dollars you have in the bank, I just stole \$500,000 of your money. I did not have to confront you in a parking lot or a dark alley or even take on the risk of a home evasion to take the money, I just printed it. No risk to my life and you may never even see my face. That's cowardice to me. Now as a thief, I'm going to deny ever taking your money, but all you have to do is look at the markets to find that people lie and markets don't.

Let me issue and control a nation's money supply, and I care not who makes its laws.

- Mayer Amschel Rothschild

Misallocations

To be honest, I don't want to believe there is inflation. Inflation frustrates markets, industry and the consumer. In markets, monies are misallocated in an effort to mitigate the effects of a diminishing dollar. Monies used to fund capital investing are instead moved into commodities and other inflation fighting assets which, in the end, create massive bubbles.

Businesses find difficulty in projecting production costs and hoarding begins to occur in order to beat the next price increase. This too contributes to the bubble as capital is bound up in advanced purchases of raw materials. For example, Algeria purchased 1.5 million tons of wheat in January, triple the amount it normally purchases. Other countries such as Saudi Arabia are also rushing to build grain supplies.¹ What is eventually produced is a series of boom and bust cycles as consumption begins to occur at irregular intervals. In the end, the consumer bears the most pain from the inflation process as nearly all costs are pushed onto the consumer.

I have been on this band wagon for nearly two years and unfortunately

the evidence is too compelling not to believe it. Since my last newsletter, I have focused most of my attention to studying the signs of inflation. The graph below illustrates various currencies and how the dollar has performed against them. Countries that have, what I consider, responsible monetary policies have appreciated the most against the dollar. Great Britain, Russia, and the European Union have similar monetary policies to the U.S. and therefore have appreciated the least while countries such as Australia, Brazil, India, Canada, etc, have actively sought to defend their economies against inflation. To add to this, countries that were commodity-exporting countries and/or commodity-based currencies appreciated the most against the U.S. dollar.

Dollar Appreciation / Depreciation

	1/1/2009 1/1/2011	Current Interest Rate	Interest Rate Direction	Commodity Exporting Country	Commodity Based Currency
Australia	-28.32%	4.75%	↑	Y	Y
Brazil	-24.93%	11.25%	↑	Y	
Indonesia	-18.61%	6.75%	↑	Y	Y
Canada	-15.24%	1.00%	↑	Y	Y
Norway	-14.48%	1.75%	↑	Y	
Sweden	-13.28%	100%	↑		Y
Singapore	-11.27%	0.60%	↓		
Mexico	-8.37%	4.50%	↓	Y	
India	-7.18%	6.50%	↑	Y	
Gt. Britian	-4.29%	0.50%	↓		
China	-2.58%	6.06%	↑	Y	
Euro. Union	2.36%	0.25%	↓		
Russia	5.19%	8.00%	↓	Y	

Source Oanda Corp Trading Economics Trading Economics IMF IMF



Proof in Commodities

Let's move on to other evidence. The following chart illustrates the 6-month increase of major commodities as of February 2011. Cotton is somewhat affected by the wet season but I know the copper crop was undamaged by the rains. In the U.S., corn ended the season with a historical high quality bumper crop, but is being distorted by the congressional mandate of 15% ethanol content in our gasoline, a 50% increase from the prior year's content requirement. There is not a week that goes by without someone I know commenting about the prices in the grocery store and at the gasoline pumps. I have heard the argument that we have seen higher gas prices in the past; however, the high prices we experienced were due to peak economic activity. We are very much below previous economic highs but we still experienced the following price increases for the 12-months ending March 3rd 2011²:

Oil (light crude)	27.96%
Heating Oil	47.99%
Natural Gas	-17.83%
Unleaded Gas	35.65%
Gold	25.31%
Silver	101.08%
Copper	34.54%
Corn	96.44%
Soybeans	51.47%
Wheat	58.13%
Pork Bellies	24.60%
Live Cattle	23.53%
Cocoa	35.96%
Coffee	114.83%
Cotton	150.92%
Sugar	42.74%

Annual Consumer Inflation - UUP vs GLD Alternate

Feb 2, 2011: UUP 22.18 GLD 130.45



Fed Actions

How is this possible with the recessed economic activity we are experiencing? I believe the answer lies with the Federal Reserve. Currently we are monetizing our debt at a rapid pace. The most current monetization is Quantitative Easing 2 or better known as QE2. The Fed is pumping another \$600 billion into the system. When more dollars are printed, existing dollars are debased. As the world's Reserve Currency, our actions affect the world. For billions of people in the world, the major cost of living is food. Is it any wonder why we are seeing food riots all over the world when 85% of all foreign exchange transactions are conducted in U.S. Dollars?³ The dollar's strength or weakness is based on the holder's perception. If one no longer believes in the credibility of the dollar, they will move to an alternate form of currency. I believe that process has begun. For the first time I can remember, the dollar did not act as a refuge for the world's

turmoil. When Egypt unrest began followed by many other Middle Eastern nations, the safe haven was not the dollar, but instead, it was gold. The above graph illustrates the dollar (blue line) versus gold (red line). As the graph depicts, as the world became more unstable in the beginning of this year, the dollar lost value while gold increased in value. The world's money found safety in gold versus the dollar.

Another sign is the price of gold. There is much talk of speculation and I would agree that a certain amount of speculation does exist, but the price of gold is not equal in the world. From January 2009 to December 2010, gold appreciated 22.6%, 30.1%, and 37.9% against the Australian dollar, South African rand and the Brazilian real respectively.⁴ Currencies not faring as well experienced an 82.7% (U.S. dollar) and 101.1% (Euro dollar) appreciation against their currencies.⁵ Countries with more conservative monetary policies experienced a smaller



increase in the price of gold versus countries with more liberal monetary policies. More troubling is how much the dollar has depreciated against gold since 1795. The following illustration depicts several events that permitted a liberal monetary policy. The War of 1812, the Civil War, the Great Depression, the removal of the U.S. dollar from the gold standard in 1971 and the current financial crisis we are experiencing.

Limestone was rare on the island and quarried at great peril. He later returned to the island with boatloads of limestone and the islanders eagerly traded their “stuff” in order to become wealthy. After some time, the islanders did indeed feel quite wealthy with their piles of limestone but they had no “stuff” to buy because they traded it all to Mr. O’Keefe. What little goods that remained were priced at levels never

policies. Without policy correction, I fear an increase in the misallocation of capital will lead to a continued volatility in the market place with booms and busts occurring at irregular intervals. This does not mean that we abandon ship and sit on the sidelines. It just means that we have to approach it differently. Hedging against inflation and taking profits more often should be part of the portfolio process for the next 5 to 10 years. I personally do not like to manage money in this manner, but my responsibility is to protect and grow your portfolio. I will remain ever vigilant.

Value of the U.S. Dollar in Terms of Gold



Rhyming with History

Mark Twain once said that “History doesn’t repeat itself, but it does rhyme.” I believe we are rhyming with the 1970’s. I often hear that you cannot have inflation unless you have economic activity, but to be honest, the last time we had inflation was in a recession. It is a natural tendency for humans to want more of something that is scarce. In this case, it is money. When the government runs out of money (recession) they just print more of it. The danger here is while we might have more money, we have less stuff. The Yap Island story is a perfect example of this scenario. In 1874, an Irishman named David O’Keefe shipwrecked on Yap Island. Prior to his rescue, he learned that the islanders used limestone as a

experienced on the island. As they learned, you may have tons (literally!) of currency but it is worthless when you have no goods to purchase.

Japan recently suffered an epic disaster. To rebuild their nation, I believe they will start redeeming U.S. Treasuries. Rather than take cheap dollars back to Japan, they may purchase our wood, steel, and other needed products to rebuild their nation. We too will have lots of dollars, but less “stuff” to purchase.

Conclusion

As evidenced in the pricing of gold, the sharp increase in the cost of commodities, and the value of the U.S. dollar, I believe the primary reason inflation is steadily rearing it’s problematic head is due to the U.S. Federal Reserve’s monetary

For more information, contact Michael A. Montileone at 412 536 8014 or mmontileone@allegHENYfinancial.com.

¹Wall Street Journal, “Don’t Trust The Inflation Numbers.”; Brett Arends

²Sources: www.money.cnn.com/data/commodities

³Marketwatch, “Daily Foreign-Exchange Turnover Hits \$4 Trillion, William L. Watts.

⁴Source: <http://seekingalpha.com/article/244591-gold-price-rising-faster-in-euros-than-in-dollars?source=yahoo>

⁵Source: <http://seekingalpha.com/article/244591-gold-price-rising-faster-in-euros-than-in-dollars?source=yahoo>

Securities offered through Allegheny Investments, a registered broker dealer, Member FINRA, SIPC

